RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Feb. 25, 1987 **LETTER 959**

Feb. 13 DJIA 2183.35; PTI 2525; A-D Ratio -3.97
Feb. 20 DJIA 2235.24; PTI 2545; A-D Ratio -3.58

THE PICTURE: "Dow Tidal Wave -- Record 2237, up 54.14," screamed the headlines in "USA Today" on February 18. For once, the newspapers were right. On February 17 almost all the major stock averages hit new record highs -- the Dow Averages, the S&Ps, the NYSE Indices, the Wilshire 5000, the AMEX, the NASDAQ, and even the Financial Times Average joined the upside parade. New highs were also struck by my faithful Primary Trend Index (PTI) and by the advance-decline ratio. Looking for discrepancies? Looking for divergences? Looking for non-confirmations? You can't find 'em in this market -- at least not yet.

Few people noticed it, but on February 17 the lagging NYSE Financial Index finally rose to a new high of 159.82. This index includes ALL the financial stocks on the NYSE: the S & Ls, the banks, the small loan companies, the brokerage stocks. You've got to consider the new high in the Financial Index as a plus (even if you're a bear).

In the last issue I wrote about the current great Wall Street paradox. The paradox is that we now have a market that looks strong and a market that acts strong. But it's also a market that is overvalued and getting more so with each day that the averages climb to new highs.

Sowhat does an old-time investment adviser(like me) say? Happily, I've been on the right side of this market all the way up, so my job is a lot easier than most. (For instance, pity the poor adviser who's been bearish for a year or so and is now -- gulp -- telling his readers to jump in and buy.) My advice is to keep calm, keep your sense of values, don't become greedy as you hear the usual Johnnie-come-lately touts on TV tell you how much money you should be making in options or stocks or commodities.

And above all, remember this (and I've written this many times before): "The trend is your friend" (assuming you know what the trend is), but "the stock market is your enemy." The stock market (be it bull or bear) is out to separate you from your money. The market looks its worst (hardest to buy) when it's a great value and near a bottom, and the market looks best (easiest to buy) when it has the least value and is near a top.

Furthermore, if you've got a weak spot, if you've got a neurotic fear, if you've got a touch of greed or a streak of egotism, the market will ZERO IN on that weakness and take full advantage of it (and that weakness will cost you dearly). You don't believe me? Ask any veteran trader or investor if that's true or not.

I've been recommending individual stocks for a number of years -- but now I've stopped. I stopped a few weeks ago when the yield on the major averages dropped to the 3% zone. Why did I stop? Because more money has been lost buying stocks at average yields of 3% than has ever been made. Maybe this time it will be different (at least I hope it will be).

But I don't think we have any right to complain. Readers of Dow Theory Letters, if they have followed my advice, have been sitting with portfolios of diversified blue-chips, and our profits in most cases have been big -- even huge. Over and over I have recommended buying the strongest Dow stocks, from Exxon to DuPont to American Can, Owens-Illinois, American Brands, and Merck to American Express, Philip Morris, Westinghouse, and Woolworth. And I've further recommended such stalwarts as JP Morgan, Bolt Beranek, American Home Products, American Water Works, Florida Power, Royal Dutch, on and on.

"Fine, Russell, great. But what do we do now?" Read the "Investment Position" section for more on this question.

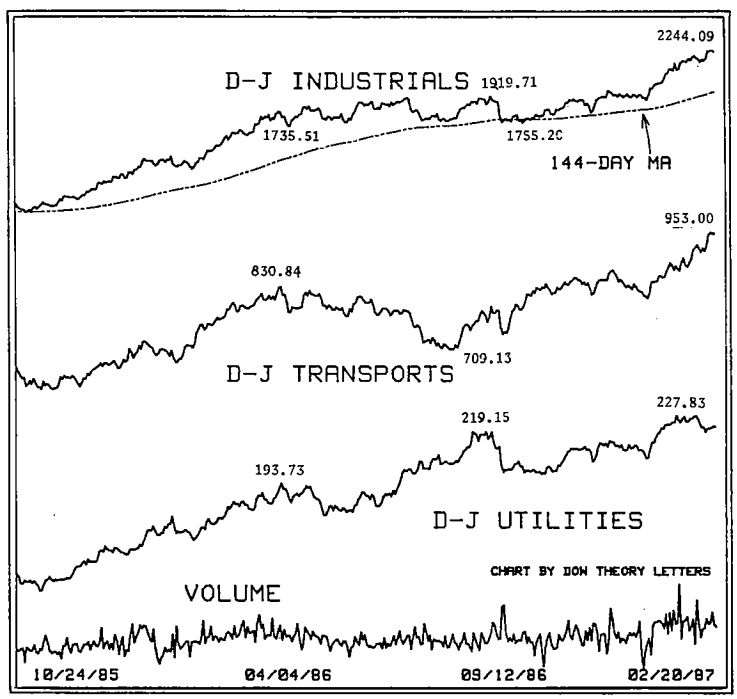
The last two Letters have been cautionary Letters. It's almost embarrassing to write cautiously in this rip-roaring market, but nobody ever paid me to write the same Wall Street blather that you can read in your daily newspaper. My caution has been based on the following considerations:

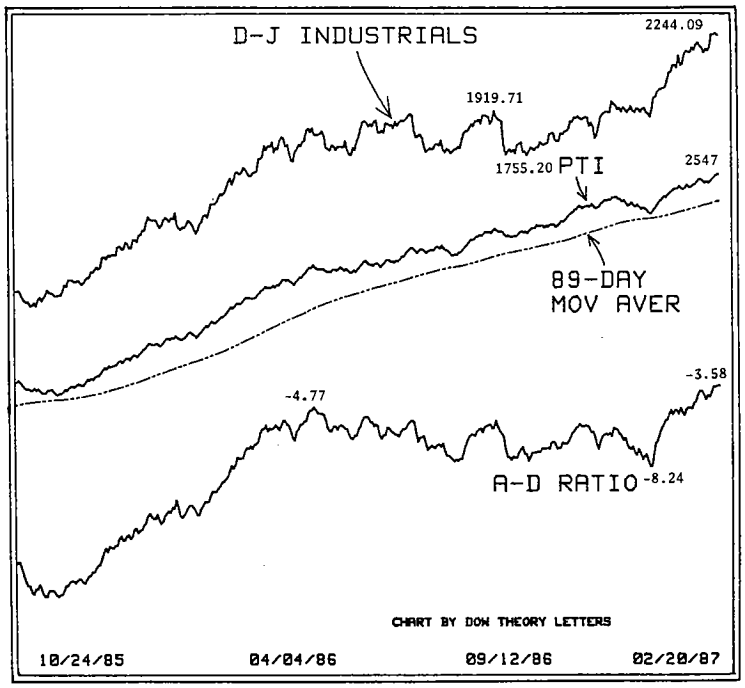
(1) The yields on the Dow and the S&P 500 have declined to dangerously thin levels. At the highs, the yield on the Dow dropped to 3.05%, while the yield on the S&P 500 dropped to 3.03%. These yields are the kind of minuscule yields associated with bull market tops.

(2) The price/earnings ratio for the Dow at the 1987 highs rose to 18.4. Based on historical comparisons, anything over 17 represents overvaluation. Many bull markets of the past have topped out with the Dow P/E ratio in the 16-19 area.

(3) The book value for the Dow is currently just under 1,000. The Dow therefore is selling at 2.3 times its book value, the highest such ratio on the record (the record started in the early 1930s).

(4) "Investment Quality Trends" of La Jolla monitors 350 investment-grade stocks (see chart in Letter 956). The percentage of these 350 stocks in IQ Trends' "undervalued group" has now dropped to an extremely low level of 12%. Based on IQ Trends' historical data, when the undervalued percentage drops to or below 15% the stock market is in the danger zone. Many reactions





and bear markets have begun when the undervalued percentage has declined to the current low level.

(5) The 200-day moving average of the Dow is now 1885. That means that the Dow is roughly 20% above its MA. On an historical basis, that's an extraordinarily large spread between the Dow and its MA. Furthermore, in any bull market (or bear market) the Dow will make occasional contact with its 200-day MA. That's something to ponder here.

(6) I will present two additional studies in this report (later sections), one based on money rates and the other on the debit/loan ratio. I urge subscribers to pay close attention to these two studies.

(7) There is a general and widely-held perception (almost amounting to euphoria) that no major correction and certainly no primary bear market can start in 1987. Many reasons for this optimistic view are advanced, such as "the January stock market barometer points to a super year," "1987 is a pre-election year, and the stock market never goes down in pre-election years," "the funds are loaded with cash and are therefore forced to buy stocks," "foreigners are viewing the US stock market as a bargain basement," "the public really hasn't entered the market yet," "major stock market cycles are bottoming here in early 1987," "business will be better than expected in 1987-88," and last but not least, "the Fed is committed to easy money as election time draws closer."

What do I think of the above list of "reasons" why we cannot have major trouble here in '87? I'm embarrassed to admit that I'm not impressed by any of them. I've heard them all before at various times. Sometimes in some markets they apply, and sometimes they don't. Do they apply today? I don't really know, but what does interest me is that so many reasons ARE BEING ADVANCED as to why we can't have a big reaction or a bear market here in 1987. As I stated above, the current sentiment amounts to a kind of euphoria, and euphoria is dangerous any time it is applied to Wall Street.

Question: Russell, you've got your PTI, and you've got the Dow Theory. Furthermore, you watch the market like a hawk. So why list all the various possible dangers? Why not just wait until you get some kind of definitive bear signal from the market itself, and then start with the warnings?

Answer: I've discussed the dangerous aspects of this market for a number of reasons. The first is that I want to provide my subscribers with a healthy antidote to all the bullish opinions and predictions that we are reading today. Look at recent issues of Barron's or Forbes or Fortune or Business Week. There are a carload of bullish "expert" opinions being expressed in those publications. Newsletters are offering additional lists of stocks to buy. Analysts are talking about another 500 or 1,000 points on the Dow during 1987. Leading economists are forecasting a decent 1987 and probably a better 1988. It may work out that way, but I want subscribers to remember that all predictions are mere guesses.

The FACT is that we now have an overvalued market. And if the market continues up from here we're going to see new all-time records in overvaluation. Now overvalued markets can go higher, but the higher they go, the more dangerous they become. That's the basic thought that I want to get across to my subscribers.

The other concept that I want subscribers to realize is that danger signals in the Averages are much more IMPORTANT when the market is in the overvalued zone. For instance, if the Dow was currently yielding 6% or 7% and selling for 7 or 8 times earnings, I would probably recommend sitting through any reaction on the thesis that a decline would simply present us with bigger bargains in equities. Furthermore, bear markets don't start when stocks are undervalued.

But at today's rarefied levels, any non-confirmation, any divergence, any sharp decline could well mark the start of a major correction or a primary bear market. Bear markets begin during periods of stock overvaluation.

Question: Russell, you've covered a lot of different concepts in this Letter already. But in your opinion, what is the most important consideration in the stock market at this time?

Answer: By far the most important consideration at this time is whether the primary trend of the market remains bullish -- or whether a bear market may be about to start. In other words, I'm getting (as you may have guessed) a bit nervous.

For years as this bull market progressed I've written, "Don't turn bearish. Don't jump to pessimistic conclusions. This is a bull market. And according to Dow Theory, we must give the prevailing primary trend (i.e., the bull trend) EVERY BENEFIT OF THE DOUBT. We have lived and invested on the basis of that concept for years."

The approach I am going to take from now on is as follows: I want the bull market to PROVE ITSELF over and over again. How do we do this? Simple, we watch to see whether the D-J Industrial and Transportation Averages can continue to register successive new bull market highs (and, of course, they've been doing just that).

We will continue to watch the PTI and the A-D ratio for confirmation of new highs in the Averages. We will also watch the Utility Average. Although the Utility Average plays no part in Dow Theory, the Utilities have, in the past, provided valuable hints as to what is coming up in the rest of the market. Recently, for instance, the Utility Average has been lagging, even though interest rates have held rather steady. I wouldn't want to see the Utilties continue on a bearish course for long.

GAPS: Question: Russell, what is the meaning of a "gap" in the Averages? Does a gap always have to be filled?

Answer: I have never seen a study of gaps that I felt successfully answered that question. For new subscribers, I should explain that a gap is a space in a stock's price movement or in a stock average wherein the highest price of one day is below the lowest price of the next day. Such a "hole" appears on a high-low chart as a gap. Gaps are formed when a stock or an average rises or falls with explosive momentum.

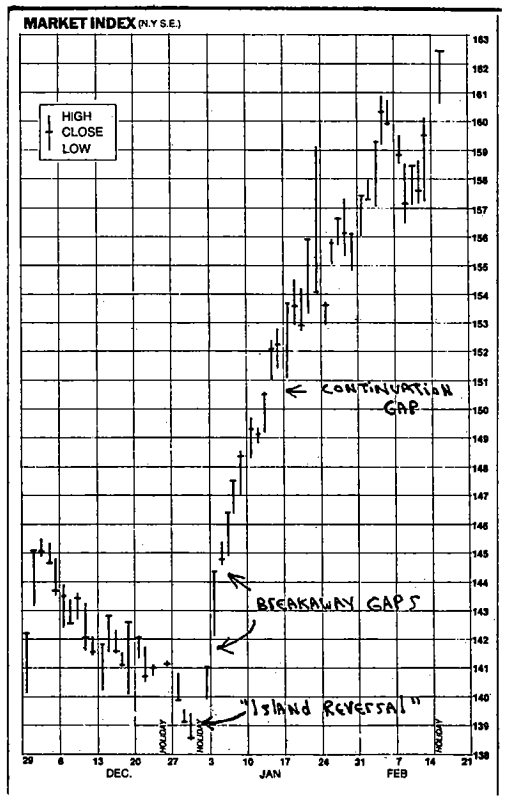
Wall Street lore holds as follows: The stock market is bound by the laws of nature, and nature abhors a vacuum. Nature likes order, and gaps are an indication of disorder. Therefore, in due time all gaps will be FILLED, either by the price movement rising to fill a

gap that was formed at higher levels, or by the price movement declining to fill a gap that was formed at lower levels.

Does this gap-fill action always occur? In the majority of cases it does, but that may merely be a way of saying that over the course of years, stocks (and stock averages) tend to move way up and way down. Thus, throughout history the majority of gaps have been closed. Whether every gap HAS TO be closed is another question, and I've never seen a satisfactory answer to that question.

Interestingly, the spectacular 1987 advance was signaled by an "island reversal" on the NYSE Index (see page 3 chart). An island reversal consists of two or more days of price action separated by gaps on both ends. On the chart we see the downside gap, then the two low days of December, then an upside gap, followed by the spectacular advance. The so-called island usually indicates a powerful reversal. An island on the top of an advance usually means that the advance is over and that the buyers have been left "high and dry." An island on the bottom of a decline usually indicates that the decline is over (as in December on the chart), and the island reversal means that the sellers have been left "low and wet" (i.e., left behind).

Following the island reversal on the chart we see two "breakaway gaps" as the NYSE Index gathered upside momentum. Then, just below the151 level we see a "continuation gap" as the spike advance continues full force. Somewhere ahead, we will probably (given the volatile nature of this market) see an "exhaustion gap" (indicating that the market has run out of steam). The exhaustion gap would probably mark the top of this move, and we could even see an island reversal form after the exhaustion gap (the exact opposite of what occurred at the December bottom). Such a formation would probably mean that the high day has been seen for the market, a high that will hold for quite some time.



INVESTMENT POSITION: As I've explained so many times before, the essence of Dow Theory is that we buy when stocks are great values and distribute when stocks are greatly overvalued. On the basis of stocks now being overvalued, I have, for the first time, mutilated our faithful bull. I have removed one of his horns, and this means that he is a weaker animal.

I've advised increasing caution as this market works itself higher, and that means that I wouldn't be averse to subscribers nailing down a few profits at these levels. The best market in the world to sell in is (1) a market that is rising and (2) a market that is chock full of eager bidders. We've got both this year, and if you like profits, you've now got an ideal market to take profits in.

Bernard Baruch said that he made his millions "by pleasing the public." When the crowd was begging for stocks, Baruch accommodated them by selling his stocks. When the crowd hated stocks, Baruch accommodated them by buying those stocks back again. At another time Baruch stated that he made his money by "selling too soon." Not an easy policy, but a pretty good policy.

From a technical standpoint, from the standpoint of the price action, we have nothing concrete yet to base any bearishness on. The Averages continue to advance to joint new highs (except the Utilities), and my PTI continues to climb above its 89–day moving average. Thus, the market's technical underpinnings remain bullish. That bull will probably never forgive me for chopping off one of his horns. But a DJIA yielding 3.03% isn't the same as a Dow yielding 6%, and I wanted some way of dramatizing this fact.

TWO ITEMS: Americans don't want to face it, but the current US "prosperity" has largely been financed through the good graces of foreigners and, to be more specific, Japan. The Japanese have been buying roughly a third of all our new federal debt over the last few years. The Japanese appetite for Treasury bonds has been literally boundless.

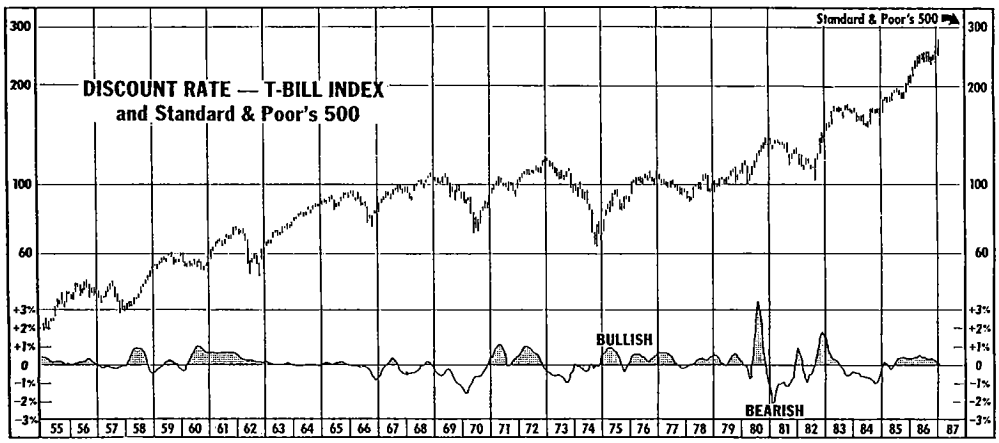
But many observers are wondering how long our current "financial nirvana" can last. Consider the position of the Japanese pension funds (which have been the big buyers of US T-bonds). As the February 7 British "Economist" put it, "The billions they (the Japanese funds) have poured into America in 1983-85 have lost 36% of their yen value, and almost every dollar that has gone in since has been worth fewer yen a month later. The exchange risk, in short, has been Japan's."

The falling dollar may be a blessing for the US tourist trade, but it worries the devil out of the Fed. Why? Because the Fed has spent the last five years fighting inflation, and if the dollar keeps falling, inflation is going to return. Furthermore, the Fed finds itself on the horns of a dilemma. If the Fed raises rates in order to keep the dollar strong and to keep foreign T-bond buyers happy, those higher rates will impact on business. On the other hand, if the Fed lowers rates in order to stimulate today's still–sluggish economy, the dollar will become even less attractive to foreigners -- and they will also be much less interested in buying US Treasury debt.

So the Fed is walking a tight–rope, and the stock market, the bond market, and the bankers of the world are scrutinizing every tick in US interest rates. It's a dangerous game the US is playing when it runs huge deficits and depends on foreign nations to buy its debt. It's a game that can't last forever, and informed observers are wondering whether forever may not be tomorrow -- or today.

All of this is not lost on the stock market as the accompanying chart illustrates. This chart was published recently by Market Logic (3471 N. Fed. Hwy, Ft. Lauderdale FL 33306). The index shown on the chart is very simple and very fundamental. It's based on the 91-day T-bill rate subtracted from the Fed discount rate (the resultant differential is shown as a 15-week moving average).

Here we see 32 years of history of this relationship. Very simply, when this differential index is in the positive position (above zero), the implication is that the money market is in a positive mode, and this is the condition that the stock market loves. Conversely, when the index is negative or below zero, the implication is that the Fed is tightening or at least passively allowing the money market to tighten on its own. Nothing bothers the stock market more than a condition of tight or tightening money.



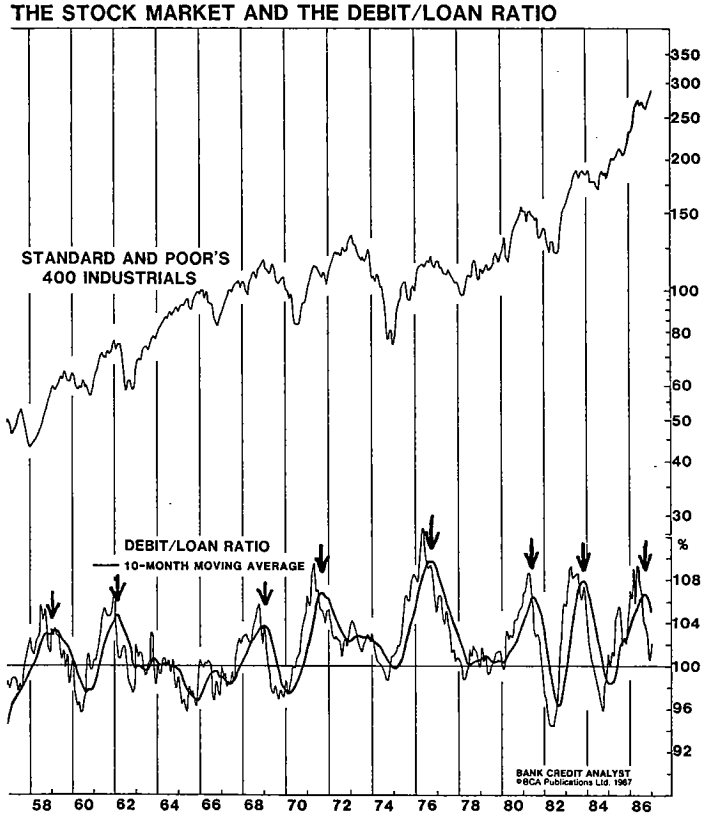
The chart is self-explanatory, and you can see for yourself that the stock market has tended to act well when the index is above zero. Of course, there have been discrepancies such as 1962 when the stock market swooned strictly for psychological reasons -- even though the index was in plus territory (the 1962 drop was based on pure fear as President Kennedy confronted the steel companies on their ill-timed price increase).

I think there is an even closer index/stock market correlation when the index drops below zero. Almost without fail, a negative index has meant trouble for the stock market.

I have shown this chart at this time because on a weekly basis the index has now turned negative. The Fed discount rate is currently 5.5% and the T-bill yield has recently risen to roughly 5.7%. While the 15-week moving average (shown on the chart) has not yet fallen below zero, it will do so very shortly if the weekly differential remains negative.

There's another long-term chart that I want to show. This is the Bank Credit Analyst's debit/loan ratio (BCA, 3463 Peel St., Montreal, Quebec, Canada H3A 1W7). I've followed this ratio for 25 years, and it's been of real help to me in understanding the market.

THE STOCK MARKET AND THE DEBIT/LOAN RATIO



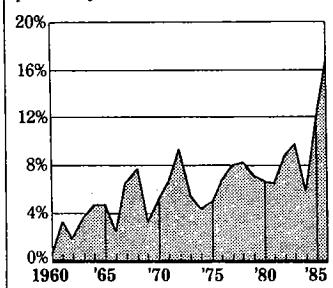
The debit/loan ratio treats the whole US as if it was a single corporation. The ratio shows bank debits (checking activity) divided by short-term loans outstanding. When business actitivy is rising and loans are slow or falling, the situation is bullish since at such times corporate liquidity is building. The oppposite is true when loans are rising and business activity is falling. So actually, the debit/loan ratio is a proxy for corporate LIQUIDITY. The ratio also tends to be a good indicator of forthcoming corporate PROFITS.

Note that the 10-month moving average of the debit/loan ratio (heavy line), having peaked a few months ago, is now falling. More ominously, it has been falling in the face of a surging stock market. The implication when the 10-month ratio is falling is that corporate profits and liquidity are going to be pressured.

This is rather interesting in view of the fact that almost every analyst and expert has been predicting higher profits in 1987 and even into 1988. So the declining debit/loan ratio coupled with my recent warnings based on MARKET OVERVALUATION present a tenuous picture for the stock market. As I said in the last Letter, the market has been skating on "thin ice." With stock yields down to their lowest levels in almost 20 years, I thought these two studies were well worth presenting.

Money Supply Growth

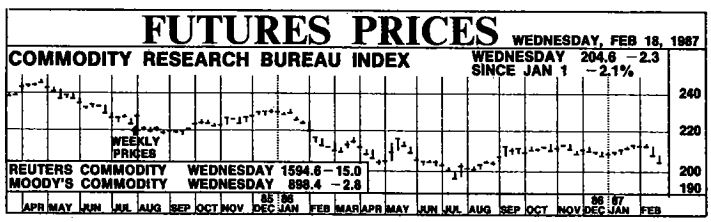
Percentage change in M1 from previous year



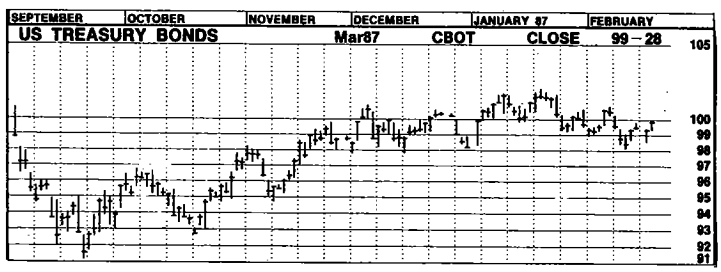
NOTE: M1 includes currency and checking accounts

CHARTS: "Is Fed's Money Policy Pointing to a Return of '70's Type Inflation?" asks the WSJ in a Feb. 19 headline. They show the accompanying chart of M-1 money supply, and as we all know, the money supply is heading through the roof. The story, of course, is that with money velocity sinking and business slow, the Fed has opened the spigots.

Surprisingly, the results, so far, have been anything but inflationary. Here's Investor's Daily's chart of the CRB Futures Index (27 different commodities),

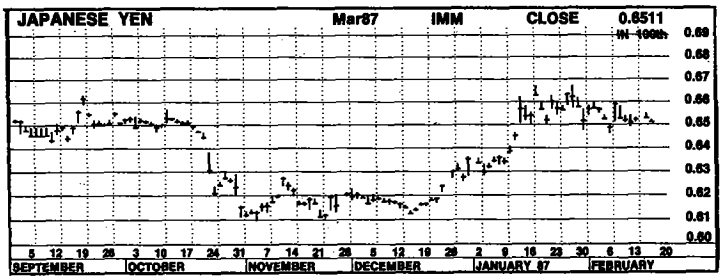

FUTURES PRICES
WEDNESDAY, FEB 18, 1987
COMMODITY RESEARCH BUREAU INDEX
WEDNESDAY 204.6 — 2.3
SINCE JAN 1 — 2.1%
WEEKLY PRICES
REUTERS COMMODITY WEDNESDAY 1594.6 — 15.0
MOODY'S COMMODITY WEDNESDAY 898.4 — 2.8
APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN JUL AUG SEP OCT NOV DEC JAN FEB
85 86
86 87

and would you believe it, commodities are headed into the tank with the Futures Index hitting 204.6 on Feb. 19. That is its lowest level in six months! The explanation: All the money the Fed is pumping out is failing to go into the economy, it is failing to go into anything productive — but it is going into the markets. Thus, goes the theory, the markets are booming while the economy is gasping.

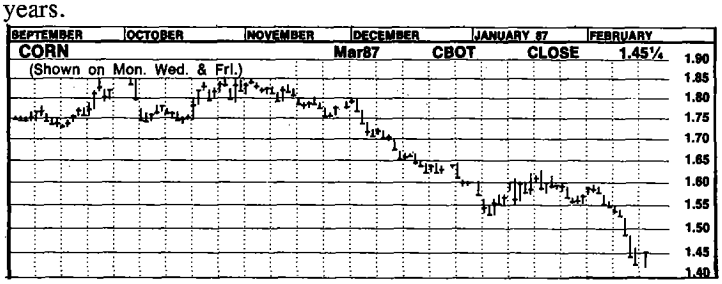


Surprise -- the T-bonds have been holding, with strong support (Mar. futures) at the 98 level. The bonds have had every chance to break -- but they haven't done so. Personally, I like the bond action, and think (contrary opinion) that we could see new highs ahead. Why have the bonds been holding so well? My own guess -- compared with stocks, bonds still offer very attractive yields. The S&P 500, for instance, yields a tiny and taxable 3.03%. The T-bonds yield 7.75% (no state tax) and good muni bonds yield 6.7% to 7.5% (no federal and no state tax).

Meanwhile, the dollar just could be exhausted on the downside -- at least temporarily. The March yen looks quite toppy, and a break below 64.5 would turn the yen very bearish. A strong dollar would be confirmed by a German mark break (Mar. futures) below 53.5.



Agricultural commodities continue to do poorly. Corn is in a wicked bear market and at 1.45 a bushel it is at its lowest price in years.



NOTES & QUOTES: The office of president of the US has changed over the years. George Washington had just three Cabinet departments: Treasury, War, and State. In 1800 President Jefferson managed a total of 2,000 federal employees. Today Reagan presides over 13 executive departments with 2.7 million employees. To help manage the tangled bureacracy, Roosevelt, in 1936, set up the Executive Office of the Presidency (EOP) comprising the White House Office and the Office of Management and Budget. Today the EOP comprises 10 units including the National Security Council, the Council of Economic Advisers, and the Office of Policy Development. Hoover in 1928 had 95 executive assistants to help him, Eisenhower had 600 appointed aides and Nixon pushed that figure to 2,000. Reagan has cut the total to 1,500, but one wonders how 1,500 bureaucrats can provide the President with any kind of cohesive information. Iran-gate says they can't.

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What are the biggest sellers in US drug stores (in units)? No. 1 is Mylanta (antacid), 2 is Fleet disposable enema, 3 is Anacin tablets, 4 is Bayer Aspirin, 5 Colgate toothpaste. In dollar amounts No. 1 is Huggies diapers, 2 Anacin, 3 Tylenol Extra Strength, 4 Advil, 5 Pampers diapers. Conclusion: lots of acid stomachs and headaches and lots of babies.

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Despite any nonsense you may have heard on the TV financial stations, rare coins have fared poorly over the last six months. On average, rare coin prices have declined about 17% since last June -- after their big run-up (about 66%) from January 1985 to mid-1986. It's the old story: just about the time the public gets hot for an item, that item tops out.

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The Third World debt problem is still huge, and it's not going away. The total of $750 billion of Third World debt has proven to be one huge headache, not only to bankers but to the various nations that want to sell more goods to the Third World nations. The problem: The Third World nations have been subject to austerity measures and stringent "emergency loans," and no matter how hard they try, there's no way they can get out from under the onus of their gigantic debts. The Third World nations, in brief, have lost their credit ratings and their ability to buy goods.

As the various exporting nations (particularly the US) chafe about their inability to sell the Third World, as unemployment and unused factory capacity in the US remains stubbornly high, pressure builds to find a solution to the export problem. And the direction appears to be toward a three-word concept aimed at the banks. The concept -- "Write it off."

So far the banks have been carrying the Third World debt at 100 cents on the dollar, even though that debt sells at a big discount on the open market. But the pressure is on for the banks to take the fall. "They're the greedy idiots who put out the loans," goes the reasoning, "let them take the fall." My own feeling is that ultimately, that's the way it's going to go. Have you wondered why the NYSE Financial Index has been such a laggard? Have you wondered why JP Morgan is the only major bank which still boasts an AAA rating? The market knows the answer. If the write-offs come (and they will), the banks are going to be writing off billions of dollars in bad loans. The result: Lousy earnings for the banks and maybe some major bankruptcies.

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As a magazine-aholic I devour magazines the way an NFL center downs pancakes for breakfast. Consequently, I read many "sleeper" publications that are terrific but are not well-known. In the newspaper category, my sleeper is the Christian Science Monitor — well-written, concise, original reporting; very strong on foreign news, art, and explanatory financial stories. An unappreciated gem and available at many newsstands (CSM, One Norway St., Boston, Mass. 02115, $114 per year, daily).

Lesser known magazines I recommend are (1) Interview, a rather chic monthly published by Andy Warhol. Excellent interviews with in-the-news people, NYC chit chat, sexy ads (19 E 32 St, NYC 10016, $20 per year). (2) Manhattan, Inc., the new "Yuppies bible." In-depth stories about the movers and shakers, particularly those from Gotham. Glossy and fascinating. (420 Lexington Ave., NYC 10170 $12 per year). (3) New York magazine, a must if you like art, food, movies, theatre, and if you want to know what's going on in the nation's culture capital. At least one top article in each issue (PO Box 51711, Boulder, C0. 80321, 66 cents an issue). (4) American Heritage, fine historical articles in each issue, great photos, superb writing. A must for history buffs. This mag was recently purchased by the Forbes family and more power to them! (Amer. Heritage -- Sub. Dept, 60 Fifth Ave., NYC 10114, $24 per year).

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The "Dunn & Bradstreet's Guide to Your Investments" is out in the new 1987 edition. This excellent 354-page soft-cover book ($10.95) is written by my good friend, Nancy Dunnan. The book covers everything from stocks, muni bonds, flower bonds and warrants to currencies and computers. I don't care how long you've been in this business, you can't put this book down without absorbing a slew of useful items. A well-written, valuable storehouse of information at a bargain price.

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Dept. of "Where or When?" President Reagan hasn't had a news conference since mid-November. I hate to say it but the word from the smart boys is that Reagan isn't a lame duck, he's a dead duck.

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With VP George Bush closely connected to Reagan and the Iran–Contra scandal, Senator Bob Dole's presidential chances are definitely looking up. Dole is probably the smartest of the potential Republican candidates. Dole is also a war hero. In the Battle of the Po Valley in Italy. Dole was a platoon leader. In combat on April 14, 1945, Dole suffered a shattered right shoulder, a broken neck, loss of one kidney and permanent loss of the use of his right arm. I guess I feel an affinity with Dole. I have a battle star for the Battle of the Po Valley. But I wasn't on the ground -- I was bombing and

strafing from the nose of a B-25. I was also luckier than Dole. I was never wounded.

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Experts are expecting an all-out war between Japanese and US auto manufacturers. In 1985 the Japanese had 25% of the US market, in 1986 they had 29%, and this year the estimate is 32%. By 1990 Japan will be able to manufacture 2 million cars in the US. That together with US producers will mean overcapacity. The prediction: Price wars coming, with a Japanese advantage because of superior production and management abilities. The outcome is almost sure to be this: US manufacturers will have to choose between market share or profits. They're not going to have both (example: GM's market share traditionally was 45%; it is now 33%).

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IBM: so much for auto troubles, how about IBM, and why has it lagged the market for so long? One reason: the excitement currently is in the minicomputer market. They sit in the corner of your office and can serve 20 to 60 terminals. Here the competiton has been fierce with outfits like DEC taking the lead. IBM's share of this market has dropped from 70% (when PC first came out) to a current 27%.

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The new technologies are creating major problems in many old, established areas. For instance, auto manufacturers were once huge consumers of steel. But the trend has been to less and less steel and increasingly more plastics and wonder synthetics. Now even aluminum use is declining. For some Third World nations, the new technologies are disastrous. For instance, Malaysia's big exports were tin, rubber, palm oil. Today, nobody wants these items, with the result that the price of tin has collapsed, natural rubber is a drag on the market, and palm oil use has plunged. Result: A very depressed Malaysian economy.

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Making money with gambling casinos is no longer "a piece of cake," and one-third of the gambling casinos in Nevada are now losing money. But they're not losing on the slot machines. Example: a slot machine costs $5,000. The Golden Nugget (Atlantic City) has 1,230 of them and last year they won $124 million from the players or an average of $100,598 per slot. Not bad for a mere machine!

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Times have changed for the independent TV stations as well. Last year ad revenue for the stations was up 8% -- but costs soared 25%. Result: several stations have filed for bankruptcy. Up to last year, investors were lined up and willing to pay 15 to 18 times a station's projected annual cash flow for a station. Now the price has dropped to 10 or 12 times cash flow.

CHART BOOKS: We had a big influx of orders for the chart books, and I had to reorder the binders. So recent requests will take about three weeks to ship -- patience please.

The first album traces the Averages going back to 1895 showing daily price action (one year to a page) of the D-J Industrials, Transports, Utilities, Bonds, and volume with notes about historical events. An invaluable source book -- $135 per album (a new page is offered each year).

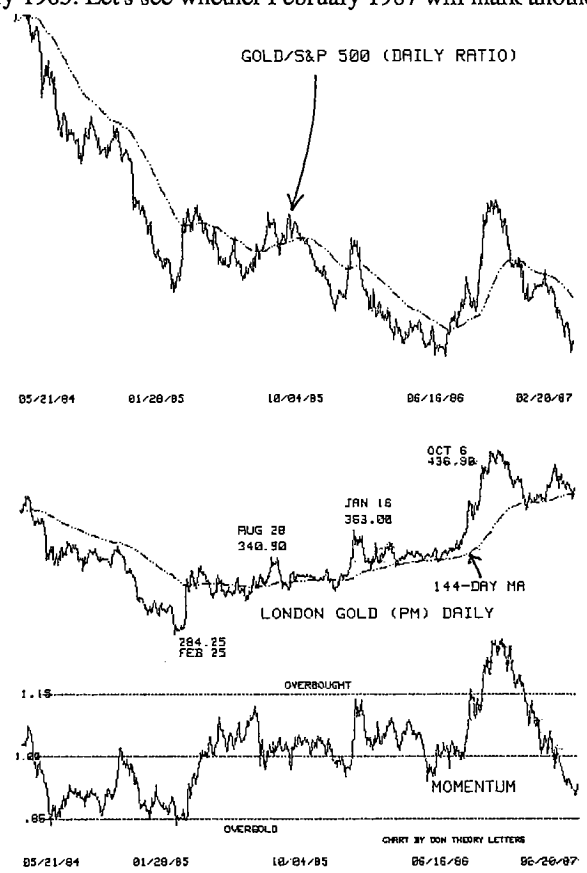
The second album takes the Dow and the A-D ratio (daily) back to 1931 (one page per year) -- $95 per album. A fascinating study of price and breadth -- nothing like these albums offered anywhere. (Please make checks out to Richard Russell).

GOLD: The yellow metal hit a low of 390 on February 18. Then last week the news broke of Brazil's inability (refusal) to pay the interest on its $109 billion in outstanding foreign debt -- and gold popped. The Brazilian "impasse" could mean that major US banks (the biggest US holders of Brazilian debt are Citibank, Chemical, and Chase) will lose half a billion dollars in interest payments over the next 90 days. Of course, the frightening part is the thought that the entire Third World debt is really a "single entity" -- and if Brazil goes, the rest will follow. Lending credence to this depressing possibility is Argentina (foreign debt $53 billion) where a top official just announced that Argentina might follow Brazil's example if commercial banks refuse Argentina's requests for new loans.

On to gold, and the accompanying chart tells the story. The gold-to-common stock ratio is simply a relative strength index. When this ratio is rising I consider the technical background bullish for gold; the opposite holds when the ratio is declining. The ratio hit a low of 135 on July 2, 1986. The ratio then rose sharply (in favor of gold), but over the last few months the ratio has been falling again. A few weeks ago on February 18 the ratio sank to 137. Then gold rallied strongly last week, pushing the ratio a few more points above its 1986 low. In other words, the ratio is telling us that since July 2, 1986, gold (hard to believe) has been acting better than common stocks -- but just barely.

At the middle of the chart we see the actual gold price along with the 144-day moving average (MA) for gold. The MA now stands at 394 and gold is literally "walking the line." I rate gold bullish as long as it holds close to (or preferably above) its rising MA.

At the bottom of the chart we see gold momentum (which is actually an 89-day rate-of-change). The momentum line has been declining steadily for four months, and it is currently approaching oversold status. Almost any concerted rally will now reverse the trend of gold momentum to the upside. But to me, the most important technical consideration is that gold momentum has come down almost to fully oversold while the gold PRICE has held ABOVE its 144-day MA. The extreme low for gold occurred in February 1985. Let's see whether February 1987 will mark another low.



LATE NOTES: When 70% or more of the stocks on the NYSE are above their 30-week moving averages, the market is considered to be overbought. As of Feb. 18, this figure had climbed to 80% -- well into the overbought zone. As explained in the last two Letters, this market is OVER-EXTENDED in both duration and extent, and it is also OVERVALUED. On top of that, the market is now OVERBOUGHT. Put it all together (including the prevalent predictions of "another 200 to 300 Dow points on the upside") and you have a situation that suggests profit taking.

NEXT MAILING: March 11